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CHARLES ELMORE

Supreme Court of the United States

October Term, 1936.

ALGERNON S. SCHAFER, Petitioner, vs. GUY T. HELVERING, Commissioner of Internal Revenue, Respondent.	No. 24.
EDWARD SCHAFER, Petitioner, vs. GUY T. HELVERING, Commissioner of Internal Revenue, Respondent.	No. 25.
LEONARD SCHAFER, Petitioner, vs. GUY T. HELVERING, Commissioner of Internal Revenue, Respondent.	No. 26.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA.

BRIEF FOR PETITIONERS.

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ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA.

BRIEF FOR PETITIONERS.

Jurisdiction.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (C. 229, No. 1, 43 Stat. 938), and Section 1003 of the Revenue Act of 1926.

This Court granted writs of certiorari on May 18, 1936, pursuant to petitions filed April 6, 1936 (R. 93).

Proceedings Below.

The writs are directed to the United States Court of Appeals for the District of Columbia which, by its opinion (R. 81-88) reported at 83 Fed. (2d) 317, affirmed a decision of the United States Board of Tax Appeals (R. 39-40) pursuant to its opinion (R. 31-39) reported at 32 B. T. A. 289, which in turn sustained deficiencies found by respondent against the three petitioners in respect of income derived from Schafer Brothers, a partnership, for the calendar year 1929.

The three cases were consolidated for trial by order of the Board (R. 40) and come before this Court on the same record of findings, testimony and exhibits.

Synopsis of the Questions Involved.

This appeal arises under the Revenue Act of 1928 and brings up the right of Schafer Brothers, a partnership holding membership on the New York Stock Exchange and composed of the three petitioners, as general partners, to inventory securities owned by said firm at the beginning and end of the tax year 1929 in arriving at the firm's income subject to income tax, and the consequent liability of petitioners as partners.

The considerations applicable are generally as follows:

(1) The right and obligation of the firm to inventory its securities in accordance with the best accounting practice in the trade or business and as most clearly reflecting the income, in order clearly to determine the income of the petitioners, as required by the Revenue Act of 1928, Section 22(c);

(2) The right of the partnership to be classified as a "dealer" in securities, under Article 105, Treasury Regulations 74, promulgated by respondent pursuant to said Act; and

(3) The effect of respondent's prior diametrically opposite rulings and interpretation of his regulations (which were not changed until over a year *after* income tax returns for 1929 were filed) upon the precise point.

Identical questions are involved in each case, since the justice of respondent's claim for a deficiency against each of the petitioners is dependent upon the amount of firm income for the year 1929.

Statutes and Regulations Involved.

Revenue Act of 1928 (U. S. C. A., Title 26, Chap. 1, p. 51), under the caption "Gross Income," provides by Section 22(c):

> "INVENTORIES.—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Treasury Regulations 74, promulgated under the Revenue Act of 1928, provides by Article 105:

> "INVENTORIES BY DEALERS IN SECURITIES.—A dealer in securities, who in his books of account regularly inventories unsold securities on hand either—
>
> (a) At cost;
> (b) At cost or market, whichever is lower; or
> (c) At market value,
>
> may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another be authorized by the Commissioner. For the purpose of

> this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule."

The above provisions of the Law and of the Regulations have persevered substantially unchanged since the enactment of the Revenue Act of 1918 in all the Acts including that of 1928.

Statement of Facts.

The findings of the Board (R. 32-34) and other undisputed facts of record are summarized as follows:

From 1918 to February, 1932, petitioners were general partners, each having a one-third interest in the New York Stock Exchange firm of Schafer Brothers, with an office and established place of business at No. 120 Broadway, New York City. The original firm of Schafer Brothers was established by petitioners' father and has been a member of the New York Stock Exchange since about 1865. Leonard Schafer had owned a "seat" since 1899 and was the "floor member," whereas the two remaining petitioners were the "office members" of the partnership. All three petitioners were actively engaged in the business of the firm (R. 32). Leonard Schafer was a "specialist" in a number of stocks traded on the Exchange.

Since its inception the present partnership was a dealer and merchant in securities on commission and on margin

(R. 33). Its principal activities included (1) the execution of orders for purchase or sale of securities upon the various Exchanges for its customers on commission and on margin, (2) the participation in syndicate and underwriting operations, and (3) the purchase and sale of securities for profit on its own account, which had always been an essential part of its business and was engaged in more extensively during the period 1925 to 1929 than theretofore (R. 33; Schafer R. 61).

Securities purchased by the partnership were acquired in expectation of a rise in the market price and for the purpose of resale, to any buyer, at a profit, and were not purchased for investment. Such transactions were entered on the partnership books in a so-called "Error Account" (the name having no significance). During 1929 the partnership purchased 107,500 shares and sold 92,500 shares of seventy-two different issues of securities, entered in the "Error Account." The number of such securities carried in that account at the close of 1929 was unusually large, due to the drop in the market and the inability to sell at a profit, but all but very few such shares were sold during 1930 (R. 33). The issue respecting the right to inventory securities is limited to those in the "Error Account."

From 1925 to 1929, inclusive, in accordance with its understanding of a ruling (R. 65-70, incl.) published by the Treasury Department in 1922 that stood continuously unquestioned for almost ten years, and as required by the rules of the New York Stock Exchange since about 1923, the firm inventoried the securities purchased and held by it for resale, at market values at the beginning and end of the year, and determined its income from this source upon the inventory basis (R. 33-34; Cornell R. 55-56; Schafer R. 59-60).

Since 1926 such inventory values were entered monthly on the firm's books (Cornell R. 54). The change of accounting method was made as a matter of business policy but with knowledge of the effect of the taxing statutes (R. 34). It is undisputed that the partnership was absolutely unable to ascertain whether it was making or losing money unless its securities were inventoried at market price both at the be-

ginning and end of the year (Cornell R. 56), and periodically (Schafer R. 58), and that *all* its securities were consistently so inventoried (Cornell R. 54).

This method of computing the firm's income was accepted by the Commissioner for all years up to 1929. For that year, when he came to audit the firm's return in 1931, he denied the partnership the right to use the inventory basis in computing its income on the ground that the firm was not a "dealer in securities" with respect to the securities which it purchased and sold for its own account that had remained unsold at the beginning and end of the taxable year.

His action resulted in increasing the firm's income for 1929 by the amount of $511,667 (in certain prior years such action would have decreased the firm's income) and consequently increased substantially the taxable income of each of the partners. Based on such increases to the firm's and to the individual's incomes, the Commissioner determined tax deficiencies for 1929 against these petitioners in the respective amounts of $33,329.20, $33,423.09 and $32,687.97.

Against these determinations of the Commissioner, petitioners appealed to the Board of Tax Appeals, which affirmed. From the decisions of the Board of Tax Appeals petitioners appealed to the Court of Appeals of the District of Columbia. That Court affirmed the Board's order, expressly refusing to follow prior decisions of identical issues by the Courts of Appeal for the Second and Third Circuits in cases admittedly indistinguishable upon their facts from the instant procedings (see R. 83-84).

Specification of Errors.

The Court of Appeals of the District of Columbia erred:

(1) In failing to hold that the use of inventories in 1929 by the firm of Schafer Bros. with respect to the securities it bought and sold for profit on its own account was essential in order clearly to determine the income of the firm, and consequently the income of each of these petitioners, in accordance with the best accounting practice, with the require-

ments of the Bureau of Internal Revenue, and with the rules of the Stock Exchange.

(2) In failing to hold that the firm of Schafer Bros. was a "dealer in securities" in 1929 as to those securities which it bought and sold for profit on its own account, and as such entitled to determine its income for 1929 upon the inventory basis.

(3) In failing to hold that respondent was precluded from arbitrarily changing a material factor in computing the firm's income for 1929, by a ruling made almost two years after the close of the taxable year at issue and more than one year after the firm and the petitioners had filed income tax returns as required by law. As will be shown, respondent's ruling made late in 1931 was exactly contrary to his prior ruling on the identical point that had been in effect unchallenged since 1922.

POINT I.

The statute entitles the partnership to the use of inventories in order clearly to determine its income in accordance with the best accounting practice in the trade or business.

For many years, including the taxable year, the purchase and sale of securities for its own account had been an important and integral part of the firm's business.

So as to determine the firm's profit or loss from its trading operations, it was essential to inventory its securities periodically at market. It would seem manifest that their cost basis would be positively misleading in determining the firm's periodical profit or loss in respect of the securities it owned, as is established by the undisputed testimony and of which this Court might well take judicial notice. The result of any such effort is graphically portrayed by the undisputed testimony of Edward Schafer (R. 58) to the effect that cost was meaningless; that if the market were up

a man who did not inventory his securities could conceal his profits; if it were down, he might be "broke" in fact, if solvent in name.

The firm was concluded by the rules of the New York Stock Exchange, which had consistently for many years prior to the taxable year required its member firms periodically to inventory their securities. It follows that securities were consistently taken up at market not only by Messrs. Schafer Bros., but also by every other firm similarly engaged, so that the periodical taking of inventories in respect of securities held *by all Stock Exchange firms* is essential to conform to the best accounting practice and most clearly to reflect the income within the precise language of Section 22c.

Since its securities were taken up monthly by the firm at inventory values on its books, such inventory values would be so reflected on its books at the beginning and end of each income tax taxable year. We accordingly submit that the annual income could not clearly be determined to conform to the best accounting practice, except by the method so adopted, and that this Court has given affirmative approval to the stand we take, as in *U. S. Cartridge Co.* v. *United States* (1932), 284 U. S. 511, where the Court said, at page 520:

> "Gains or losses must be accounted for in the year in which they are realized. The purpose of the inventories is to assign to each period its profits and losses. *Lucas* v. *Structural Steel Co.*, 281 U. S. 264, 268. The tax laws are calculated to produce revenue ascertainable and payable at regular intervals. Otherwise it would not be practicable to devise methods of accounting, assessment or collection capable of operation. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 365. The taking of petitioner's inventories at market value was essential to a proper disclosure of its financial position."

The inventory basis has been determined to be required by the best accounting practice in the same business, in *Estate of Hall*, 29 B. T. A. 1255, 1258, aff'd *sub nom. Comm.* v.

Stevens (2nd C. C. A., 1935), 78 Fed. (2d) 713, where the Board said (with respect to a firm engaged in the same type of business as Schafer Bros.):

> "It was customary in the trade or business of dealers in securities to inventory securities on hand at the end of each year at the market price. This method conformed to the best accounting practice in that trade or business. Dealers in securities follow this method because their transactions occur on the market basis. Securities used as collateral in connection with loans from banks are also valued at market, and reports made to the New York Stock Exchange are on the basis of market value, as well as cost. The method of inventorying securities on hand at market would be used in the best accounting practice in a financial balance sheet."

Since the use of inventories is necessary in order clearly to determine the income of the firm, then under Section 22(c), Revenue Act of 1928, there appears to be no option in the matter—"inventories shall be taken"—their use is mandatory.

With this requirement Schafer Bros. complied. Over a period of years they consistently inventoried at market prices their unsold securities at hand, and used such inventories in computing annual profit and loss. The firm's practice in this respect consequently complied with the two tests relative to the use of inventories promulgated by respondent in *Article 102* of Regulations 74: *First,* the firm's inventory conformed to the custom and best accounting practice in the security business for financial balance sheets and for general accounting, and, *secondly,* it was consistent, which we agree with respondent to be of paramount importance.

We concede the distinction between the application of the inventory rule to a partnership with an established place of business, and the individual stock trader.

Schafer Bros. was engaged in the business of trading in securities. It was an essential part of the firm's activities. The firm had an established place of business and kept a full set of books to reflect its trading operations in accordance with the requirements promulgated by the New York Stock Exchange, of which the firm was a member.

A partnership, even for tax purposes, is a quasi entity. The taxable income of its members is entirely derivative, being based on each member's share of the firm's income as a whole. Each partner is therefore concluded by the firm's method of keeping its accounts; he has no option as in the case of the individual trader.

The latter frequently keeps fragmentary records or no books at all. From practical considerations it would be difficult, if not impossible, for the Commissioner to permit him the use of inventories.

Where, however, the partnership as such not only values its securities periodically at market, but is required to do so by the rules of its Association in order most clearly to reflect its income in accordance with the best accounting practice, the use of inventories in computing the partnership income, as such, is mandatory upon the Commissioner and should be enforced by the Courts.

This first point of our brief is not directly concerned with the question whether the partnership was or was not technically a "dealer" within the provisions of Section 105 of Regulation 74.

Our previous argument is directed to the mandatory scope of the statute itself, the effect of which cannot be whittled away by any regulation in derogation thereof.

We also maintain, and hereby urge—

POINT II.

The partnership was a dealer with respect to the securities purchased with the view to sale at a profit, and was empowered by the respondent's regulations to inventory the securities in its "Error" account.

Article 105 of Regulation 74, heretofore quoted at pages 3 and 4, has been in effect in identical language since the Revenue Act of 1918 was enacted, under all Acts including that of 1928, except for the elimination for the Regulation in 1926 of a comma, hereinafter discussed.

Under that Article, one who maintains the right to be classified as a dealer in securities must comply with nine specific requirements. As summarized by the Court below (R. 85):

> "The regulation is that a dealer in securities, with an established place of business, regularly engaged as a merchant in the purchase of securities, not for investment, but for resale to customers with a view to gain and profit, is entitled to have his income computed on inventories."

Analysis of Article 105.

Detailed analysis of Article 105 discloses the following prerequisites to classification as a dealer in securities as that term is defined in the Regulations:

(1) "* * * a description of the method employed shall be included in or attached to the return * * *."

(2) "* * * all the securities must be inventoried by the same method * * *."

(3) "* * * such method must be adhered to in subsequent years * * *."

(4) "* * * a dealer in securities is a merchant of securities, whether an individual, partnership or corporation * * *."

(5) "* * * with an established place of business * * *."

(6) " * * regularly engaged in the purchase of securities and their resale to customers * * *."

(7) "* * * that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom * * *."

(8) "* * * If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment * * *."

(9) "Taxpayers who buy and sell or hold securities for investment or speculation (no comma) and not in the course of an established business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule."

We contend that Schafer Bros. complied with all the foregoing prerequisites, and the Court below has agreed with that contention as to the majority of such prerequisites.

It has tacitly accepted the expressed views of the Courts for the Second and Third Circuits (affirming 29 B. T. A. 1255 *sub nom. Estate of Hall*) in their decisions in *Commissioner* v. *Stevens* (1935), 78 Fed. (2d) 713, and *Commissioner* v. *Charavay* (1935), 79 Fed. (2d) 406, which held to be without merit as a preclusion to the use of inventories (1) the failure to disclose *on the return* a description of the method employed.* The Court for the Second Circuit reaffirmed this view in its decision in *Vaughan* v. *Commissioner,* decided August 10, 1936, not yet reported, but found in paragraph 9446, C. C. H. Tax Service.

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*We may be permitted to state that the method employed *was* disclosed and was known to respondent. Agents of respondent examined the firm's return—see notation "Field Audit" stamped on the face of the return, signifying that Schafer Bros.' books of account and records of its business for 1929 were examined by a Revenue Agent (R. 62 A)—and the deficiency notices herein show that respondent did have actual knowledge of the method employed (R. 10, 18, 27), before any deficiency was asserted.

The Court below recognized that Schafer Bros. (2) inventoried all its securities by the same method, (3) adhered to that method in all subsequent years after its adoption, (5) had an established place of business, and (6) engaged regularly in the purchase of securities, not for investment, but for resale at a profit.

Basis of Decision by the Court Below.

But although the Board *found as a fact* (R. 33, line 3) that "the partnership was a dealer and merchant of securities on commission and on margin" and the Court below found that the firm "was licensed to do a stock brokerage business, which we assume would include buying and selling on commission and *dealing* generally in what are popularly known as marketable securities" the Court based its conclusion on the untenable premises that the firm (4) was not a "merchant" of securities, (7) did not sell to "customers," (8) that its trading activities were a "branch" of its business, and (9) that its purchases and sales were "speculations."

Lower Courts in Conflict.

In so holding the Court, as itself states, falls directly, and we maintain erroneously, into conflict with the decisions of the Courts of the Second and Third Circuits in the *Stevens* and *Charavay* cases above cited, frankly conceding, however, that this case is indistinguishable on the facts from those cases.

Stevens and Charavay were members of the brokerage firm of Stevens & Legg, as these petitioners were members of the firm of Schafer Bros. The firm of Stevens & Legg bought and sold securities for and upon order of its customers, as did Schafer Bros. It participated in syndicates and underwritings, as did Schafer Bros. It was a specialist as to certain stocks, as was Schafer Bros. Stevens & Legg also bought and sold securities for its own account, making its purchases from or through other brokers on the Exchange, making its sales the same way, all exactly as did Schafer Bros.

Yet the Courts of the Second and Third Circuits decided that, as to securities thus bought and sold for that firm's own account, it was a merchant, that the brokers through and to whom it sold were its customers, and that such transactions were consummated, not as speculations, but "with a view to the gains and profits that may be derived therefrom," with the resulting conclusions that the firm of Stevens & Legg was a dealer in securities and entitled to the use of inventories in computing its income. We rely upon those decisions as controlling of the case at bar.

The restriction imposed by the Court below is justified neither by statute nor the Regulations.

The views of the Court below would confine classification as a dealer in securities under the Regulations solely to underwriters and other original distributors of securities. No such restriction is evidenced nor attempted either by the statute or by the Regulations. Nor is there any reason for such a restriction which would favor such distributors over taxpayers *regularly engaged in the security business in all its phases* who make a practice of buying and selling for their own account.

We invite attention to the emphasis placed by Congress upon the activities of *an established business* in its definition of a "dealer" in securities contained in the Securities and Exchange Act of 1934 (Sec. 3[a]):

> "(5) The term 'dealer' means *any* person engaged in the business of buying and selling securities *for his own account, through a broker or otherwise,* but does not include a bank, or any person in so far as he buys or sells securities for his own account, either individually or in some fiduciary capacity, *but not as a part of a regular business.*" (Italics ours.)

Any concern regularly engaged in the business of trading in securities is a "dealer." A trader is a "dealer."

The term "dealer" has received considerable judicial consideration, and we respectfully invite attention to the term as judicially construed, in "Words and Phrases" (First Series, Vol. 2, pp. 1859 *et seq.;* Second Series, Vol. 1, pp. 1222 *et seq.;* Third Series, Vol. 2, pp. 811 *et seq.;* Fourth Series, Vol. 1, p. 699).

The essential attribute of a dealer, as so defined, consists in his reliance upon favorable fluctuations in the market for the commodity or security.

> *Comm.* v. *Vetterlein* (Pa., 1906), 63 Atl. 192, at p. 193 (214 Pa. 21).

Accord: In re I. Rheinstrom & Sons Co. (D. C. Ky., 1913), 207 Fed. 119, where the Court at page 136 defined a "dealer" as:

> "* * * one who buys to sell again. He stands intermediately between the producer and the consumer, and depends for his profits, not upon the labor he bestows on his commodities, but upon the skill and foresight with which he watches the markets."

He is not a processor but a trader. See *State* v. *Rosenbaum* (Conn., 1907), 68 Atl. 250, 80 Conn. 327, where the Court said at page 251:

> "* * * A dealer is one whose business it is to buy and sell as a merchant, shopkeeper, or broker—a trader. Century Dictionary. A trader is one who makes it his business to buy merchandise, goods, or chattels to sell the same at a profit. Bouvier, Law Dictionary."

So, in *In re Hemming* (D. C. Miss., 1931), 51 Fed. (2d) 850, the Court said at page 851:

> "The words 'dealer' and 'trader' are synonymous; 'dealer' being one whose business is to buy and sell as merchant, shopkeeper, or broker, and 'trader' one

> making business of buying merchandise, goods, or chattels to sell at profit. A dealer is not one who buys to keep or makes to sell, but one who buys to sell again, a middleman between manufacturer or producer and consumer."

Accord: White Mountain Fur Co. v. *Whitefield* (New Hamp., 1914), 91 Atl. 870, where the Court drew an interesting distinction in holding that the plaintiff would not be a "merchant" of foxes if he purchased them with a view to selling their increase or their pelts, proceeding (at p. 872):

> "The question is: How does the plaintiff expect to make its profit, by buying and selling foxes, or by raising foxes and selling them."

The term "merchant" implies a dealer with an established place of business.

Although we do not contend that the terms "dealer" and "merchant" are necessarily synonymous, we beg leave to emphasize the distinction that is implicit not only in the general conception of the terms but in the Regulations themselves. *A "dealer" becomes a "merchant" when he acquires an established place of business for his trading activities.* Judicial sanction for our contention is contained in *Kansas City* v. *Ferd, etc., Co.* (Mo., 1903), 73 S. W. 302, 303, 98 Mo. App. 590, where the Court said at page 303:

> "* * * It does not follow, because a merchant is a dealer, that a dealer is also a merchant. A merchant must have a store, stand, or other place where he sells his goods. A dealer need not have such store, stand, or place to keep and sell his goods. He may buy and sell without such aids to his business."

Accord: Brown v. *Commonwealth* (Va., 1900), 36 S. E. 485, the Court saying at page 486:

> "A merchant's license contemplates that the merchant is to have a fixed place of business within a county or city,—a store or shop for the sale of goods. This is the common acceptation of the term as given in 2 Bouv. Law Dict., p. 155."

So a certain degree of continuity and volume would also appear to be requisite for a dealer also to be classified as a merchant. Both prerequisites are met by the record herein.

Although we believe the above qualifications of these terms to be strictly correct, there is respectable authority for failure to differentiate at all between the attributes of a dealer and a merchant. Thus, in A. R. R. 755, *I-1 Cumulative Bulletin 225* (R. 65-70), upon which petitioners relied in inventorying the firm's securities, respondent adopts the following definition given in Webster's New International Dictionary:

> "The term 'merchant' * * * includes 'any one making a business of buying and selling commodities,' 'a trafficker,' 'trader' or 'one who trafficks on a large scale.'"

We have no quarrel with the line of cases denying classification as a dealer in securities to parties engaged in trading in securities as a spasmodic or sole enterprise, as distinguished from an integral activity of a general Stock Exchange business as was the case with Stevens & Legg and with Schafer Bros.

Illustrative of such decisions is *Seeley* v. *Commissioner* (1935), 77 Fed. (2d) 323, decided by the Circuit Court for the Second Circuit (and distinguished by the same Court in its later decision in the *Stevens* case, *supra*), wherein it was held that a floor trader, not engaged himself in a general security business, could not qualify as a dealer in securities in respect to his personal trading ventures.

A further illustration is afforded by *Wilson* v. *Commissioner,* 76 Fed. (2d) 476, wherein it was held that the taxpayer, who was merely a selling agent for a securities firm, having no established place of business of his own, was not himself a dealer.

Adirondack Securities Corp. v. *Commissioner,* 23 B. T. A. 61; *Northeastern Surety Co.* v. *Commissioner,* 29 B. T. A. 297; and *Oil Shares Incorporated* v. *Commissioner,* 29 B. T. A. 664, complete the list. In those cases the taxpayers were denied classification as dealers in securities because they engaged in trading on their own accounts, not as a part of

a general business in securities, but as sole and distinct ventures.* The foregoing decisions all contain a fundamental factual distinction from the case at bar which accentuates the soundness of the Court's views in the *Stevens* case. A taxpayer who buys and sells securities does not thereby become a dealer in securities. But where, as here, a taxpayer engaged in the general security business with its numerous phases, already clearly a dealer within the meaning of the Regulations as to some of its activities, buys and sells securities for its own account for profit as an integral part and activity of its general business, it is likewise a dealer as respects its trading activities. Its securities are bought for resale to *any* customer at a profit. Its customers are those who buy from it, whether brokers, upon sales made through the Exchange, or other buyers. So the Court held in the *Stevens* case, and we contend correctly.

The effect of the decision below is to attempt a segregation, both actual and accounting, of the correlated and inseparable functions as dealer, broker and underwriter engaged in by this firm as essential activities of its general securities business. Some of the difficulties and resulting confusion which would arise from such attempt are pointed out by the Securities and Exchange Commission in its recent report to the Congress. (See "Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker," June 20, 1936, Government Printing Office.)

The buying and selling of securities was an integral part of the partnership business.

We challenge the view expressed by the Board and adopted by the Court below to the effect that the buying and selling by Schafer Bros. for its own account was a separate branch of its business and may be so treated for tax purposes.

* But see *Harriman National Bank* v. *Commissioner*, 43 Fed. (2d) 950, where the bank was held to be a dealer as to securities bought and sold for its own account, an activity which had long been an integral part of its general banking business.

Opposed to that is undisputed testimony that such trading was an *essential part* of the firm's business in 1929 and for fifty years before (R. 61) and the Board's own findings (R. 33), particularly as respects the years 1925 through 1929. Naturally the firm's own trading was kept separate on its books; its own purchases and sales were not commingled nor confused with the orders it executed as brokers for its clientele.

Naturally, also, this firm, as broker, trader and dealer, had varied business activities. But for more than fifty years buying and selling securities for the firm's own account had been an essential part of its business. If such an activity is not an "integral" part of a business nothing can be. As well to say the keeping of accounts, the billing of customers, the buying of supplies, are *separate branches* of a business as to hold separate a continuous activity initiated with the founding of the firm.

The buying and selling of securities was carried on from the same place of business, under the same direction and management and simultaneously with the other business activities of the firm. We respectfully submit it must be held to be an essential, integral part of the firm's business as a dealer in securities.

Elements of speculation in the purchase and sale of securities do not preclude classification as a Dealer.

The Court below has laid undue emphasis upon the speculative elements inherent in the firm's trading accounts.

May we, first and foremost, emphasize that if the element of speculation were held the determining factor, classification as a dealer would be inadmissible not only for any concern doing a business in securities, but to the very "merchant" whether of securities, commodities or merchandise, whom the Court below has sought to place upon a higher plane.

It goes without saying that not only an underwriter of securities, but the owner of a general store as well, engages in speculation. *Speculation is inherent in any business for*

the proprietor's own account. For so long as he owns property, whether real estate, commodities or securities, he is subject to the vicissitudes of the market.

This elemental and self-evident truth must lead to an interpretation of Regulation 105 in accordance with established experience.

The kernel of that Regulation as applied to the instant situation is contained in the last sentence, which we venture to repeat *in extenso* to emphasize our argument:

> "Taxpayers who buy and sell or hold securities for investment or speculation (no comma) *and* not in the course of an established business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule."

The purpose of that Regulation is two-fold:

1. It seeks to deprive the holder of securities for investment of the right to inventory, and justly so, since the investor has acquired his securities for the income they yield, and not to reap an appreciation of principal. Daily, monthly, or even yearly fluctuations in market value play no part in the transaction he has visualized.

2. The last sentence of Regulation 105 further limits the right to inventory to those engaged in an established business. The considerations necessitating such restriction have been previously adverted to and require no enlargement here.

The penultimate clause of that sentence is also highly significant in denying the right of inventory to *officers* of corporations and *members* of partnerships buying and selling securities *in their individual capacities.* These words reiterate the emphasis upon the predicate of an established business.

The two words "or speculation" in that sentence must, therefore, be deemed qualified by the succeeding words, "and not in the course of an established business."

Judge Learned Hand, in *Seeley* v. *Commissioner*, *supra*, has suggested the interpolation of a comma after the word "speculation" and changing the succeeding word "and" to the word "or."

Suffice to say that the Regulation has persevered in this form under every Revenue Act since that of 1918 with a rather significant exception that commencing with the Revenue Act of 1926 respondent *eliminated* a comma which did appear after the word "speculation" in Regulations 65, 62 and 45 in force under the Acts of 1924, 1921 and 1918. (See C. C. H., Consolidated Income Tax Laws, § 326, at p. 272.)

The elimination of the comma by Regulations 69, proclaimed under the 1926 Act, is carried over into Regulations 74, quoted *supra*. *If the comma belongs anywhere, it is before the words "or speculation."*

It follows that the element of "speculation" is immaterial from the strict language of the Regulations so long as the buyer and seller of securities "speculates" in the course of an established business.

But we do not limit our contention to the strict linguistic basis. We maintain that unless the privilege to inventory is withdrawn from any party who deals in commodities or securities for his own account, both the Commissioner and the Courts must allow for substantial elements of speculation in the transaction under scrutiny.

We accordingly maintain, prerequisites 2, 3, 5, 6 (including other brokers), 4 and 7 (in an established place of business), 8 (not for investment) of Section 105 having been met, that the Regulation can be construed to deny the right to inventory only (1) if the securites are acquired for investment, or (2) if not in the course of an established business.

The buying and selling of securities by the firm for its own account was not however "speculation," and the firm in so doing was not a "speculator."

In their emphasis that the partnership "was apparently a speculator and not a dealer within the regulations," the Board and the Court below had manifest reference to the fact that the firm bought securites in hope of reselling them at a profit. Of course it did. So does the underwriter of a fifty million dollar bond issue. So does a grocer who buys

a case of canned tomatoes. So does every entrepreneur who buys and sells any property, but that is not necessarily speculation.

Yet the market may change on tomatoes as well as on securities: the hoped-for profit may be lost to an underwriter or to a grocer as quickly as to a trader in securities. Somewhere there must be a line between the *trading* of a dealer and the *speculating* of a speculator, as that term is material here, since we know of no exception to the rule that all buying and selling is done in the hope of profit.

We maintain this firm is found on that side of the line with the *dealers,* not the *speculators;* that its buying and selling of securities was *trading,* not speculating—"with us, it was a trading proposition" (Cornell R. 57). The firm *was not buying on margin* as was the taxpayer in *Hammitt* v. *Commissioner,* 79 Fed. (2d) 494. That fact serves sharply to distinguish the case now at bar from the *Hammitt* case and points a distinction here, since the Court below considered marginal trading as speculation.

Here, the securities were purchased outright: paid for in full. This firm bought stocks and put them in its portfolio, just as an underwriter purchases bonds, just as the grocer buys tomatoes; and put them on their respective shelves, for resale at a profit "to any customer." (Another broker is a customer—*Commissioner* v. *Stevens, supra.*) The securities could have been sold to anyone who would buy, either at private sale or through the Exchange.

"Speculation" infers a great risk on a small stake; a legalized "gamble" perhaps. "Dealing" or "trading" infers a normal buying and selling on a sound basis. Both are done in hope of profit, of course, but in "dealing" or "trading" both risk and profit are smaller, sounder, more normal.

The conception of a dealer for which we contend is sustained by the "wash sale" provision of the Revenue Act of 1928 and the Commissioner's Regulations thereunder.

As further evidencing the correctness of the decision in the *Stevens* case, we invite attention to the evident intention

of Congress to enact the so-called "wash sale" provision as a corollary to the inventory privileges granted dealers in securities—a circumstance alluded to by the Court below in its opinion (R. 88).

The Commissioner, by his Regulations (Article 661 of Regulations 74), interprets Section 118 of the 1928 Act as follows:

> "A taxpayer, other *than one in the trade or business of buying and selling securities,* cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities, if within 30 days before or after the date of such sale or other disposition he has acquired (otherwise than by bequest or inheritance), or has entered into a contract or option to acquire, substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. * * * This provision is designed to prevent a taxpayer who owns securities, *other than one in the trade or business of buying and selling securities,* from claiming as a deduction in computing net income the so-called 'loss' sustained from a sale of securities which is immediately followed or immediately preceded by a purchase of substantially identical securities." (Italics ours.)

No occasion for making the exception in question should arise unless the excepted classification of taxpayers were permitted to inventory their securities.

The criterion to be applied with respect to inventories as well as the "wash sale" provision is, therefore, whether the taxpayer is engaged as a business in the purchase and sale of securities and, for this purpose, an established place of business and evidence that purchases and sales of securities are an essential part of the taxpayer's business, are necessary factors.

In this connection we invite attention to the testimony of Mr. Edward Schafer (R. 59). The partnership herein was not within the "wash sale" provision. It could have sold the securities in the "Error Account" and repurchased the same securities the following moment, but the sales would

have constituted closed transactions upon which a deductible loss would have been established. *It would be an absurd perversion of the Revenue Act to urge that a taxpayer who may establish his losses by a "wash sale" is compelled to go through the motions.*

Moreover, denial of the right of Schafer Bros. to use inventories would lead to confusion in accounting.

Respondent's determination would have required the partnership to adopt conflicting methods of bookkeeping for its securities.

Respondent has not attempted to disturb the firm's practice of inventorying at market securities held in its syndicate and participation operations. The extent of those operations is shown in Exhibit 1 (R. 63-65) for the years 1926 through 1929.

Since the operations last mentioned and the trading operations conducted in the "Error Account" were both essential parts of the business of the firm, the absurdity of carrying one group of securities at market and another group of securities at cost appears on its face, *particularly in the light of the Stock Exchange regulations.*

If the use of inventories is necessary in order clearly to determine the income derived from syndicates and participations, there is no rhyme or reason for denying the right to inventory with respect to the trading accounts which were entered into for precisely the same purposes and under substantially the same conditions as the syndicate and participation operations.

There may or may not be a distinction that, in the case of the trading accounts, the securities were purchased and sold *through* brokers, but that is an obviously immaterial factor, as was held in the *Stevens* case.

We accordingly submit that the definition of a dealer properly extends to any established firm "in the trade or business of buying and selling securities" as a part of a general se-

curity business and that the findings and evidence respecting the nature of Schafer Bros.' business impel the application of the inventory provisions of the Regulation.

POINT III.

Schafer Bros. were entitled to inventory their securities for 1929 in reliance upon the long-established Bureau practice of prior years and the expressed views of the Bureau on the subject and respondent is now precluded from retroactively changing the basis of determining income.

The evidence shows that the partnership, in inventorying its securities, relied on a Ruling made in or about 1922 as respects the right of a trader in securities to use inventories (R. 55-56, 59-60). This Ruling was published as the opinion of the Committee of Appeals and Review, A. R. R. 755, I-1 C. B. 225, found as Exhibit 2 for Identification, at pages 65 to 70 of the Record.

The Committee on Appeals and Review was a reviewing group *within* and *a part of* the Bureau of Internal Revenue, established by the Commissioner himself. Its duties were to review the conclusions of other sections and officers of the Bureau respecting specific issues and cases and its rulings thereon represented the final decision *of the Bureau,* thereafter serving as guides both to the Bureau and to taxpayers (*Klein, Federal Income Taxation,* 36: 6(b): Article 1006 (A. R. M. 219), III-1 C. B. 319).

A. R. R. 755, when issued in 1922, was, therefore, the final decision of the Bureau upon the issue here involved, and was cited with approval by the Bureau in 1923 in Income Tax Unit Ruling (I. T.) 1818 II-2 C. B. 39. *It remained undisturbed by the Bureau until 1931.* It constituted an instruction to this firm to inventory the securities it owned. In 1923 the New York Stock Exchange passed it on to its members by requiring them to inventory their securities, and the firm complied with both instructions.

The ruling on which the partnership relied determined that a trader engaged in business as a buyer and seller of securities with the purpose and expectation of resale at a profit within a short period of time, and not for the purpose of investment, would have the right to inventory securities held by him at market in the computation of his taxable income.

Neither the language of the statute nor the regulations of the Commissioner on the subject of inventorying securities have changed in any material respect since the above decision by the Committee on Appeals and Review, which covered the activities of that particular trader for the years 1918 and 1919. The Regulation in force under the Revenue Act of 1918 and subsequent Acts have remained identical with Regulations 74, Article 105, except for elimination of the comma after the word "speculation."

The consistent interpretation placed by the Commissioner upon the statute respecting inventories through the decision of the Committee on Appeals and Review in A. R. R. 755 and its later approval in I. T. 1818, on which petitioners relied, preclude the application of a contrary retroactive ruling after a period of nine years.

The Government must adhere to the interpretation established continuously since 1922, not only by reason of its own rulings, but even more by reason of its administrative practice of allowing the use of inventories. The evidence is uncontradicted that the partnership had predicated its income subject to tax by the use of inventories at all times since 1924 without any effort by the Commissioner to enforce any change. In fact, with the ruling of the Committee on Appeals and Review before it as the only guide for interpretation of the statute, the firm of Schafer Bros. was compelled to inventory the securities in its trading account. Any other course of procedure would have been legally erroneous at the time the firm's income tax return for 1929 was required to be filed.

The practice followed by the partnership was developed and promulgated under the Revenue Act and Treasury Regulations as far back as 1918 and has been ratified, confirmed and acquiesced in by the enactment of statutes and the promulgation of regulations *employing the same language as the earlier enactments.*

Where a statute has been construed by a judicial, legislative, executive or departmental authority and has been re-enacted in the same or substantially the same terms, the Congress is presumed to have been familiar with its construction and to have adopted such construction as a part of the law.

This Court has consistently held that statutory interpretations by executive, administrative or departmental authorities, such as the Treasury Department, in relation to the Tariff Act (*National Lead Co.* v. *United States* [1919], 252 U. S. 140), the Interstate Commerce Commission (*New Haven R. R.* v. *Interstate Commerce Commission* [1905], 200 U. S. 361), a State tax board (*Copper Queen Mining Co.* v. *Arizona Board* [1906], 206 U. S. 474), tariff authorities (*United States* v. *Baruch* [1911], 223 U. S. 191), immigration authorities (*Nagle* v. *Loi Hoa* [1927], 275 U. S. 475), and the Postmaster General and the accounting officers of the Treasury (*United States* v. *Alabama R. R. Co.* [1891], 142 U. S. 615), will be followed by the Courts where the same provision of the statute is adopted or re-enacted for many years without change.

In *Edwards* v. *Wabash Ry. Co.* (C. C. A., 2nd Cir., 1920), 264 Fed. 610, which involved the application of a stamp tax to certain exchanges of stock certificates, the Court said at page 618:

> "* * * Congress, by re-enacting the act without substantial change in the provision now under consideration, *adopted the construction which the Treasury Department for 15 years had placed upon it.*" (Italics ours.)

The first attempt by respondent to refute the controlling effect of A. R. R. 755 came with his promulgation of General Counsel's memorandum (G. C. M. 9656), which appears in X-2 Cumulative Bulletin 127, issued during the latter part of 1931.* This was a year and a half after the partnership and the individual partners were required to file and did file their income tax returns for the year 1929. They were compelled to rely upon A. R. R. 755 (approved by I. T. 1818), which was the only binding interpretation of the law and regulations in force up to that time, *and so relied to their detriment by failing to avail themselves of the "wash sale" provisions (see Edward Schafer, R. 59).*

These considerations the Court below brushes aside (R. 87-88)—even though granting that "the Bureau's willingness to leave undisturbed the practice until 1929 was induced by the larger tax accruing to the government"—on the ground that equity cannot correct a wrong done a citizen by government, however shocking. The inequities are so apparent we need not argue them. But we respectfully submit that mere gross injustice is not the only factor to sustain our contentions.

Here, respondent, by statute, was authorized to prescribe the use of inventories in such situations as, in his opinion, they might be necessary to conform to the best accounting practice and to most clearly reflect income. In Articles 102 and 105 of his Regulations he named such situations. A. R. R. 755 and I. T. 1818 interpreted those provisions of the Regulations for the guidance of respondent's agents and taxpayers as well. Those Regulations and those interpretive rulings stood unquestioned for almost ten years through enactment by the Congress of three or more successive Revenue Acts, thereby receiving Congressional approval and, consequently, the force and effect of law.

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* That ruling had reference to an individual who maintained an office for the purchase and sale of securities as his sole vocation. On its face the ruling should have no application to a partnership that purchased and sold securities in connection with its general securities business. Furthermore, the definition of "merchant" adopted by that ruling was predicated upon the archaic conception of a merchant under the ancient bankruptcy acts, and invokes the narrower comparative of a "tradesman" rather than the broader and more modern simile of a trader with an established place of business. The ruling also limits the term "dealer" to one who buys and sells *for the account of others*, which is manifestly incorrect, since such a person would be a broker or agent, and not a principal.

Respondent in now thrusting upon these petitioners and their firm a new basis for computing income is not attempting merely to change his interpretation of the law, as the Court below infers, but is in reality attempting to change what has become the law itself.

No decision of this Court or of any other judicial body impelled the Commissioner's *volte face* as respects a partnership with an established business.

Since he permitted his interpretations to stand until they assumed the strength of law, and since these petitioners relied thereon to their detriment in computing their incomes and that of their firm for 1929, on a basis thereby directed and consistently used, respondent is estopped from arbitrarily imposing upon them a new basis of computation which he has discovered to be financially more advantageous.

CONCLUSION.

We respectfully submit that the assignments of error be allowed, that the decisions of the Court of Appeals and of the Board of Tax Appeals be reversed, and that the distributable income of the petitioners from the partnership of Schafer Bros., and their corresponding income tax liability for the calendar year 1929, should be redetermined on the basis of inventorying securities owned by the partnership at the beginning and end of the calendar year 1929 at the then prevailing market values thereof, as computed at the trial by stipulation (R. 51).

Respectfully submitted,

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